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SUBJECT: DEPUTY SECRETARY LEW'S MEETING WITH PALESTINIAN AUTHORITY PRIME MINISTER FAYYAD

REF: JERUSALEM 185

Classified By: CG Daniel Rubinstein, reasons 1.4 (b) and (d)

**¶11. (C) Summary.** In a February 21 meeting with Deputy Secretary Jacob J. Lew, Palestinian Authority (PA) Prime Minister Salam Fayyad stressed the importance of Israel ending Area A incursions and creating conditions for the Palestinian private sector to generate sustainable economic growth. He said that the PA's fiscal retrenchment efforts -- both on expenditures and revenue -- were paying off, and that he expected the deficit to drop 5% in 2010. He also expressed appreciation for the delivery of budget support and the alignment of U.S. assistance to fit the PA's focus on smaller projects that deliver immediate results. End summary.

Alignment of U.S. Assistance to PA Plans, Budget Support

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**¶12. (C)** In a meeting with Deputy Secretary Lew on February 21 in Ramallah, Fayyad expressed appreciation for U.S. budget support and the realignment of U.S. assistance to fit the PA's shift in strategy to smaller development projects that can be implemented more quickly. He said that this strategy allowed the PA to focus on marginalized areas and show responsiveness to the needs of local communities. While most of the projects cost less than USD 200,000, they contributed to economic growth and shored up political support for the PA, he said.

Ending Area A Incursions

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**¶13. (C)** Fayyad described how an improved security environment in the West Bank, a seeming impossibility in 2007, had become reality. He noted improvements in personnel and leadership had an immediate positive impact, evidence of the importance of institution building. Fayyad stressed the importance of making security sector reform a local effort, both on the ground and in the public's perception. He said that U.S.-supported train-and-equip efforts for the PA security forces had evolved and become more "administrative" in nature.

**¶14. (C)** Fayyad expressed concern about ongoing Area A incursions by the Israeli Defense Forces (IDF). These undermined the PA's security forces and gave the impression that the PA is "subcontracting for the Israelis." He said the IDF had entered Ramallah twice on February 20, but made no attempts to arrest anyone or otherwise give any reason for the incursions. Fayyad asserted that security coordination between the GOI and PA had never been better, a fact, he said, that even the Israelis acknowledged. He urged that

threats be countered through GOI-PA coordination, rather than by a physical Israeli presence in Area A. The PA's security forces have demonstrated capacity, and now is the time to extend their presence to all Palestinian population centers in the West Bank, he said. Not only would this be a political deliverable, it also would be "invisible to main street Tel Aviv," according to Fayyad. He drew a contrast between the visible (and therefore presumably more difficult) removal of checkpoints and the ending of Area A incursions, that he said would be nearly invisible to the Israeli public.

The Deputy Secretary noted that Israelis recognized the progress made on security, and understood that economic conditions were tied to security improvements.

#### Improved Governance at the Local Level

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¶15. (C) Responding to the Deputy Secretary's query about the durability of the institutional reforms that had been implemented, Fayyad said that the PA's focus on capacity building and institution building over the last year had paid off. He noted that a year after Hamas's win in the January 2006 elections, "the system had ground to a halt." But the systems put in place over the last three years, and the civil service base, would make the progress hard to undo. As an example, Fayyad pointed to the increased accountability at the local government level. During a visit to 13 villages near Jenin on February 18, he was struck by the local municipalities' responsiveness to their residents and their achievements in more efficient management structures and finances.

#### Private Sector Growth, not Fiscal Stimulus

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¶16. (C) Fayyad said that even before the GOI began to ease movement and access restrictions in 2009, the West Bank economy was showing signs of growth, with the positive trend going back to 2007. He said that while double digit growth was possible, real sustainable growth had to start with the private sector, not fiscal stimulus. The private sector needed access to markets in Israel and beyond, and the removal of physical restrictions (back-to-back requirements at the crossings, checkpoints in the West Bank) to grow, Fayyad said. The most damaging part of this web of restrictions, he said, are the functional restrictions on a wide range of inputs. He described the restrictions as capricious, informal, and poorly understood. As a result, companies had difficulty planning -- some were forced to keep 70 days of inventory (much higher than the norm), a huge tie-up of capital that had a negative impact on growth. Despite these restrictions, some companies had been able to adapt and even flourish, he noted, pointing to Palestinian pharmaceutical companies now exporting to Europe.

¶17. (C) Part of this growth, he said, was due to the PA's repayment of its arrears and financial obligations incurred during the Hamas and National Unity Government rule, front-loaded by the release of revenues by the GOI. He noted that the regularization of payments instilled the private sector with confidence and opened the door to growth. He also noted that any economy injected with this large a fiscal stimulus and open to imports would demonstrate short-term growth.

#### Curbing Expenditures and Increasing Revenues

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¶18. (C) Fayyad said that the PA's fiscal retrenchment is paying off. In 2009, the PA required USD 1.34 billion in external budget support, and in 2010 he expected a 5% reduction in that figure. He said the reopening of Gaza could deliver serious revenue and have an immediate positive impact. Prior to the closure, 30% of the PA's total revenue was collected in Gaza. Now, Hamas is collecting that money instead of the PA, he said.

¶9. (C) Fayyad said the PA was making progress on ending the "irrational subsidies" that amounted to about \$500 million annually, primarily in the form of utility payments deducted by the GOI from the PA's revenue transfer. Previously, Fayyad said, the municipalities knew the central government would be held accountable for the utility bills, so the few payments collected were diverted to other uses. Now, particularly in the Central West Bank where electricity was supplied by the Jerusalem District Electric Company (JDECO), service was being cut off when municipalities didn't pay, according to Fayyad, and the improved security meant that JDECO could carry out the cutoff.

¶10. (C) Similar measures were being undertaken in Gaza to increase collection of electricity payments. The Gaza power plant hearkened from an old era when "business and government were one and the same," according to Fayyad. The PA paid NIS 40-45 million/month to the GOI for 120MW (not a low cost option, he said), but only received 50-60MW from the power plant. Fayyad estimated that the Gaza Electricity Distribution Company (GEDCO) collected a mere 10-14% of money owed, but following the termination of the EU's fuel subsidies and the PA's gradual cutback in subsidies beginning in January (reftel), Fayyad said GEDCO would be forced to start handing over money it collected. GEDCO did have resources, Fayyad asserted, noting the company had paid NIS 5 million in January and another NIS 4 million in February for fuel. Fayyad estimated that the cutback in fuel subsidies in Gaza would save the PA USD 60 million in 2010, or 1% of GDP.

Bottom Up and Top Down in Parallel

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¶11. (C) Fayyad stressed that bottom-up institution building alone could not end the occupation; the political process was essential. He said that this process must begin, because the Palestinians stood to lose the most without it. He noted that his statebuilding efforts had stirred up debate within Israel and resulted in three different views: the first group was reminded of their own "bottom-up" statebuilding experience; the second was apprehensive; and the third viewed

his efforts with concern and outright hostility. He said he had been very transparent about his goals and that he intended to create positive facts on the ground. If, two years on, the political process hasn't ended the occupation, he said, these facts would help create pressure for an end.

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